LIVING TRUSTS IN A NUTSHELL
a great estate planning tool

A living trust is a great estate-planning tool. Here's why.

<u>what is a trust</u>

First, what is a trust? A trust is an entity, similar to a corporation or a limited liability company (LLC), used for the purpose of holding and managing a person's property. It is formed under state law and has three essential persons: the **grantor**, the **beneficiary** and the **trustee.**

The **grantor** is the person who creates the trust. The grantor is sometimes called a settlor or a trustor. The grantor creates his/her trust by signing a written document, which explains how the trust property is to be managed and who shall benefit from the trust. The grantor then contributes property (money, stock, personal effects, real estate) to the trust. Title to the trust property is held in the name of the trust. For example, a bank account might be held in the name of the John Doe Family Trust.

The **beneficiary** is a person who benefits from the use and enjoyment of the trust property. A beneficiary's interest is called a "beneficial interest." This beneficial interest can be either immediate or in the future or both and can be either a right to enjoy the trust income or principal or both. In contrast with a stockholder of a corporation or a member of an LLC, a trust beneficiary rarely has any voting rights.

The **trustee** manages and retains or distributes the trust property in accordance with the trust instrument. A trustee can simultaneously serve with another a co-trustee or later serve as a successor to another trustee who has died or has resigned his duties. A trustee can be an individual person or an institution, *e.g.* a bank or trust company. A trust will never fail for want of a trustee. If a successor is not named, a court will appoint one.

The trustee and successor trustees should be persons with whom the grantor has confidence. These persons should be competent and disinterested; *i.e.* having no present or future interest in the trust property and capable of managing the trust property and of responding to the interests of the trust beneficiaries. For this reason, some grantors will prefer a professional trustee (a bank or trust company) in order to avoid any risk of having the trust property mismanaged or worse yet, taken by a less than partial trustee, who could favor his/her own interests over the interests of other beneficiaries! An estate planning professional should offer helpful advice in selecting trustees.

Like a corporation and an LLC, a trust can exist a long time. A trust will terminate when its property has been distributed, but not later than when the trust requires final distributions be made. Unlike a corporation, most states will not permit a noncharitable trust to exist indefinitely. In Montana, a noncharitable trust can exist for at least 90 years (or even longer as permitted by Montana's statutory rule against perpetuities, a rule far too complex to discuss in this article). For most noncharitable trusts, 90 years will be far longer than needed to accomplish the grantor's goals.

the living trust v. testamentary trust

The **living trust** is a trust that exists during its grantor's life. It is also called an *inter vivos* trust (means "among the living" in Latin). In contrast, a **testamentary trust** has life only when its creator dies, because the testamentary trust derives from the probate of a person's will. Many estate plans will involve either a living trust or a testamentary trust, or even both. With very few disadvantages, the living trust offers some significant advantages over the testamentary trust. The remainder of this article explains why and how these living trusts can be used in estate plans.

the revocable trust v. the irrevocable trust

A living trust can be revocable or irrevocable. A **revocable trust** is similar to a person's will, because it can be changed anytime before the grantor dies. The revocable trust is not a device to avoid paying the grantor's creditors. An irrevocable trust cannot be changed and is intentionally used to make permanent, irreversible gifts to individuals or charities. An irrevocable trust is typically used for making tax advantaged charitable gifts, for optimizing tax free or tax minimized gifts to heirs, and for assuring the lifetime care for a special person in need.

Neither the revocable and irrevocable trust can be used to circumvent paying the grantor's debts. However, both can be used to protect the interest of beneficiaries other than the grantor.

Most estate plans involve revocable trusts, as opposed to irrevocable trusts, since most people are not willing to give up ownership of their property until they die. The remainder of this article explains how the revocable trust can be used in estate plans.

the revocable trust - cares for the grantor while living & avoids conservatorships

While the grantor is alive, the grantor of a revocable trust retains total control of his/her property. While alive, the grantor is often the sole trustee and sole beneficiary of his/her own revocable trust (commonly referred to as a self-trusteed trust). While alive, the grantor of a revocable trust can always change the named beneficiaries of his/her trust estate.

When a person becomes become incapacitated (*e.g*. Alzheimer's or a stroke or other illness), someone has to manage his property for him/her. States, like Montana, provide a formal judicial process, called a conservatorship, for handling an incapacitated person's property. The revocable trust can provide a less costly alternative to the conservatorship. When the grantor of a revocable trust becomes incapacitated, his/her named successor trustee will take over managing the trust property and then use the trust income and property to care for the grantor and his/her spouse. Because the revocable trust can avoid a conservatorship, it has a significant advantage over the testamentary trust.

the revocable trust - cares for the grantor's survivors & avoids probate

The I.R.S. disregards the revocable trust as a separate identity for tax purposes and requires the grantor to use his/her own social security number for the trust. Nevertheless, all states, including Montana, will respect a revocable trust as an entity for holding property. When a grantor dies, his/her revocable trust remains alive! On the grantor's death, the property in the trust will simply pass free of probate to its named beneficiaries (just like insurance proceeds can pass directly to a beneficiary without going through probate). To successfully avoid probate, the grantor's property must be held in his/her trust at the time of death. In contrast with the revocable trust, a testamentary trust cannot can avoid probate, since it originates from the probate of a person's will.

In most cases, the fear of paying extravagant probate fees may be more overblown than real. Yet, it is generally easier to account for and transfer a person's property to a revocable trust during his/her life than through probate. Even though the cost of setting up a revocable trust and transferring property to it will be incurred while the grantor alive, the alternative of deferring those costs is likely to be outweighed by the costly burden of having to clean-up a person's affairs in a formal judicial proceeding (probate) after he/she has died. The revocable trust is a valid mechanism for avoiding a probate.

warning - probate avoidance cannot be guaranteed

Although probate avoidance is often sought-after, no professional can guarantee complete probate avoidance. For example, suppose a person dies in a car accident. There is no effective way to assign his/her estate's wrongful death claim to his/her revocable trust. The dying man's last dying gasp (likely out the anyone's presence) is not likely to be: "I assign all of my right, title, and interest in my estate's wrongful death claim to my revocable, living trust." Or, when a person dies while reading the winning numbers on his/her lottery ticket, did he/she remember to tell the grocery clerk that he/she had purchased the winning ticket in the name of his/her revocable living trust? Or how would a person know to assign his/her inheritance to his/her trust, when coming from a great aunt that had died a few minutes earlier? In these situations, there is little that can be done to avoid a probate. The problem of a potential probate is solved by a pour-over will, as explained later in this article.

the revocable trust - minimizes estate taxes

The revocable trust (as well as the testamentary trust) can be used to minimize the federal estate tax, which presently threatens estates over $1,000,000. For this purpose, a person's estate includes life insurance, jointly held property, assets held by a revocable trust, probate and other nonprobate assets. One fundamental tax saving strategy is accomplished by allowing each spouse to separately pass his/her own $1,000,000 to the next generation. By properly utilizing separate $1,000,000 exemptions, a husband and wife can double the amount that can pass estate tax free to the next generation. This strategy can be achieved with minimal economic "loss" to the surviving spouse. These tax saving strategies are often accomplished by one or more of the following subtrusts, *i.e.* trusts within the revocable trust:

the **marital subtrust** holds property in trust for the benefit of a surviving spouse. This property will pass tax free to the surviving spouse and will not be taxable in the grantor's estate, but will be later taxable in the surviving spouse's estate.

the **nonmarital subtrust** (also referred to as a **credit shelter subtrust)** holds property in trust for the benefit of the surviving spouse. This property will be taxable in the grantor's estate, but won't be create a tax liability, if funded with property not in excess of the grantor's $1,000,000 exemption. Thus, the nonmarital trust should be funded with no more than $1,000,000 in assets (even less if <u>taxable</u> gifts were made during the grantor's life) in order to avoid an estate tax. Any trust property in excess of the $1,000,000 exemption will be diverted into and used to fund the tax free marital subtrust. *The $1,000,000 exemption is scheduled to change in 2004 and thereafter. See chart below.*

the **QTIP subtrust** (means "qualified terminal interest property") holds property for the benefit of the surviving spouse and as single trust can double for both the marital and nonmarital trust.

the **disclaimer subtrust** holds property for the benefit of a surviving spouse who has refused to accept all or part of a deceased spouse's outright gifts, purposely keeping property from passing over to and bunching up inside the survivor's estate; this subtrust is particularly useful in allowing post mortem estate planning by the surviving spouse, especially considering the uncertainty of when a person is going to die in relation to the programmed changes in the estate tax exemptions.

The scheduled changes in estate tax exemptions look like this:

year of death	**estate tax exemption per person**
2002-2003	$1,000,000.00
2004-2005	$1,500,000.00
2006-2008	$2,000,000.00
2009	$3,500,000.00
2010	the estate tax is eliminated this year only!
2011 and later	back to $1,000,000.00

Taxwise, these changing exemptions have made estate planning more difficult, simply because no one knows when he/she is going to die. Congress may also make further changes in the estate and gift tax laws.

the revocable trust - protects children and grandchildren but equal is not always fair

In a revocable trust (and also in a testamentary trust), the **children's** and **grandchildren's subtrust** (sometimes called a **surrogate subtrust**) is used to protect a younger beneficiary or beneficiaries from prematurely inheriting property. A person needs to consider what happens without a surrogate subtrust.

Often, a person without a will designates his/her spouse as the principal beneficiary of his/her life insurance and then leaves the remainder "equally to each of my children, if my spouse does not survive me." This is a poor man's estate plan. In some instances, the insured would be better off without the insurance. Why?

First, a young person may lack the maturity to handle large sums of money, when reaching the age of emancipation, 18 years of age. No person alive can predict how mature his/her own 3 and 5 year old children might be, when later reaching the age of 18. An unprotected gift to an inexperienced 18 year might even be used as an excuse for not having to go to college (the very reason for the gift)!

Second, if both parents die (e.g. in a car accident), "equal" is not always fair or what a person should really want. For example, assume it costs $1,000 per year to raise a child. An insured and his/her spouse die in an auto accident leaving 3 minor children, aged 13, 8, and 3 as equal beneficiaries of a single $30,000 life insurance policy. The 13 year old will be $5,000 ahead, when he/she reaches 18, the age of emancipation (not necessarily the age of maturity). The 8 year old will break even and the 3 year old will be $5,000 in the hole. *These amounts are used for simplicity of illustration and not to suggest that a $30,000 life insurance policy would be* *adequate to care for such a family.* Or suppose one child needs an expensive medical procedure. Would anyone write a will that reduced that child's inheritance simply because his care as a child cost more than his siblings?

The surrogate subtrust can defer, slow down, or otherwise control the premature disbursement of funds to a beneficiary who might otherwise be a spendthrift, inexperienced, or imprudent with money. This subtrust can also provide a more equitable division of benefits among a person's children or grandchildren, taking into consideration the diversity of the age, health and needs of all of the beneficiaries within the group (called a class). In solving these problems, the experienced estate planner must listen to his/her client's needs and then offer choices and recommendations. Then, the client chooses which fits his/her own needs the best.

the revocable trust - enhanced with a pour-over power of attorney

What if a person becomes incapacitated before his/her property has been transferred to the revocable trust? This problem is solved by using a "pour-over" power of attorney, authorizing the incapacitated person's agent to transfer his/her property to the revocable trust! The pour-over power of attorney performs the same function as a pour-over will, except it has vitality while the grantor is alive as opposed to after he/she has died. In contrast with a will, a power of attorney dies, when its principal dies.

the revocable trust - enhanced with a pour-over will

To protect against the unexpected possibility of an probate, a proper estate plan will include a pour-over will. The pour-over will passes all probate property into the grantor's revocable trust. This is the essential purpose of the pour-over will and assures consistency in the estate plan.

living wills

A living will is not a will. It is an important component of the estate planning. However, the living will has nothing to do with disposing of property. It is simply used to direct how a person wants to be treated by his/her physician and health care providers, when terminally ill and can authorize persons (usually a spouse or other family members) to make those health care decisions. It is simple and a good idea.

charitable & other kinds of trusts – legitimate and illegitimate

Charitable gifts are usually more advantageous, taxwise, if made during a person's life. Charitable trusts commonly offer the donor the opportunity "to have his/her cake and eat it, too." Charitable trusts have created a whole new vocabulary of crazy acronyms; such as: the CRAT (charitable remainder annuity trust, CRUT (charitable remainder unitrust), CLAT (charitable lead annuity trust) and CLUT (charitable lead unitrust). Charitable trusts divide property interests in a single property between the charity(ies) and the donor, usually leaving the charity with an income interest or with a remainder interest and the donor, with the other part. These planned gifts are irrevocably made during a person's life and are too complex to discuss in this article.

There are other kinds of noncharitable trusts, too. The generation skipping trust or subtrust is used to bypass at least one generation of heirs and to avoid one or more generations of estate taxes. The GRIT (grantor retained income trust) is designed to downsize the taxable value of taxable gifts in very large estates. The Crummey trust (named after Mr. Crummey) is not crummy, but in fact very useful for making tax excludable gifts that protect premature distributions to younger beneficiaries. However, the "Offshore" trust can be a legitimate entity, but is not a legitimate device to escape income tax. Read "Don't believe in the tax fairy" in "Your Turn" of the Independent Record on 2/13/2003. The "business" trust is a legitimate entity, but is far less favored than the LLC and the corporation for conducting an active trade or business (in Montana a "business" trust is treated like, and presumably taxed like a corporation)!

conclusion

Although some people perceive the living trust to be a tool of the rich and only for those who can afford pricey lawyers, that perception is incorrect. Contrary to this common misperception, an able estate planner should and will seriously consider a revocable trust as the centerpiece of his/her client's estate plan. But a good estate planner will want to spend time with his/her client, gathering essential information and analyzing his/her client's needs. This process could take several meetings and will likely require the client to do some homework. Bottom line, a good estate planner will not try to fit everyone in the same size shoe. Cheap estate plans do. Cookie-cutter estate plans and mail-order, computerized software programs will likewise fail to provide the needed wisdom and insight that an experienced estate planner can offer. A conscientious person will want to wear a "shoe that fits." That person should give serious thought to using the living trust in implementing his/her own successful estate plan.

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